No. 13105.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

RAYMOND W. CLAWSON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANT'S OPENING BRIEF.

STRONG & SCHWARTZ,
9441 Wilshire Boulevard,
Beverly Hills, California,
Attorneys for Appellant.

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

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I.

Jurisdiction.

Appellant was charged in an Information and convicted under the Internal Revenue Act, 26 U. S. C. A. 145(a) [C. R. 1].[1] The District Court had jurisdiction under Section 24 of the Judicial Code (28 U. S. C. 41 (a)). Judgment was entered and Notice of Appeal was filed on May 21, 1951 [C. R. 37-39]. This Court has jurisdiction under Section 128 of the Judicial Code (28 U. S. C. A. 225).

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[1]The references "C. R." are to the Clerk's Transcript on appeal; the references "T. R." are to the typewritten transcript of testimony on appeal; the references "Govt. Ex." and "Deft. Ex." are to the Government's exhibits and the appellant's exhibits, respectively.

Statute Involved.

Section 145(a) of the Internal Revenue Code insofar as applicable here provides:

> *"Failure to file returns.* * * * Any person required under this chapter * * *, or required by law or regulations made under authority thereof to make a return * * * who wilfully fails to * * * make such return * * * at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than one year, or both, * * *."

Statement of the Case.

Appellant was arraigned before the United States District Court for the Southern District of California, Central Division, upon a one count Information filed in the name of the United States Attorney [C. R. 1], charging that appellant had violated the Internal Revenue Code by failing to file an individual income tax return for the year 1946 [*Id.*]. Appellant was tried, after his plea of not guilty [C. R. 8], before the District Court and a jury, and was found guilty as charged [C. R. 31; T. R. 828]. After appellant's various motions [C. R. 32-35; T. R. 431-435, 786][2] had been denied [C. R. 36, 431-435, 787], the District Court sentenced appellant to imprisonment for a term of one (1) year [C. R. 36].

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[2]Discussed more fully below.

Specification of Errors and Points of Law.

I.

The record does not contain that minimum quantum of evidence which the law requires to sustain a verdict of guilty upon the offense charged in this case.

II.

The District Court erred in denying appellant's motion for a Bill of Particulars.

III.

The District Court erred in refusing to entertain appellant's motion for return of illegally seized property and for the suppression of evidence.

IV.

The District Court erred in admitting certain evidence offered by the Government.

V.

The District Court erred ln refusing to accord to appellant the opportunity of obtaining evidence to refute matters as to which appellant was caught by surprise.

VI.

Appellant was denied due process by virtue of the action of the prosecutor in shifting his theory of the case after all of the evidence was in the record.

VII.

The Court erred in giving to the jury certain instructions offered by the prosecution.

VIII.

The Court erred in refusing to give to the jury certain instruction requested by appellant.

IX.

The Court erred in refusing to grant the motion for a new trial.

X.

The District Court erred in admitting into evidence the second-degree hearsay testimony and the hearsay medical records. The documents were privileged and the prosecution therefore illegally obtained and utilized them.

XI.

The prosecutor deprived appellant of a fair trial by improperly cross-examining appellant, by misstating the law and the evidence in the case and by improperly exhorting the jury to return a verdict of guilty.

Summary of Argument.

The conviction of appellant constitutes a gross miscarriage of justice. His conviction is not supported by substantial evidence, is based on improper arguments and theories of the prosecution, and on errors in law, and is encumbered by denials of due process. These are all discussed fully below.

Statement of Facts.

The facts, in brief, are as follows:

Appellant was born in 1906 in San Jose, California, the grandson of Sarah Names of Oakland, California [T. R. 525].

His grandmother, a wealthy woman, gave to him directly and indirectly and sent to him through the Postal-Telegraph Co., and Western Union Telegraph Co., be-

tween $10,000 and $15,000 a year during most of his adult life, until shortly prior to her death in 1945 [T. R. 245, 253-254, 329-330, 337-338, 435-449, 473-479, 528-531, 736-742].

Prior to 1944, appellant did not engage in any gainful employment for more than a very brief period [T. R. 245, 329, 472-475, 528, 736-737, 742]. As one of the concomitants of having a rich and generous grandmother, and also a wealthy wife, appellant produced no "income" as that term is defined for income tax purposes [T. R. 329, 339, 530-531, 619-620, 737-742].

(It may be stated parenthetically here that it is appellant's contention that in 1946, the year involved in this case, he still did not receive the minimum gross or net income of $500,—which would have necessitated his filing an individual income tax return for that year.)

During the year 1946 appellant did not file an individual income tax return.

For several years prior to 1946 appellant was the principal spirit behind Clawson Enterprises, Inc., a California corporation, a holding company, incorporated in February, 1944 [T. R. 18; Govt. Ex. 1]. In 1944, 1945 and 1946 this Corporation operated a cafe and bar called "Clawson's Restaurant," and, in 1946, a newspaper, the "Crenshaw-Mirror," and two boats, the "Artemis" and the "Conqueror" [T. R. 597-600, 743-744].[3]

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[3]It should be noted at this point that due to the Government's shifting in this case between the *"alter ego"* theory and the "constructive dividend" theory, as discussed more fully below, it is impossible to determine whether the Government agrees with or disputes these facts. Indeed, a definite decision will have to be made by the Government as to which facts it intends to accept as the evidence most favorable to it under whatever theory it adopts.

Appellant had incorporated Clawson Enterprises, Inc., hereinafter called the Corporation, after full advice by an attorney, Frederick H. Clapp, of Los Angeles [T. R. 743-744].

Out of a total of 120 shares, appellant held one share of the stock in the Corporation, his stepfather owned one share, Kathleen A. Clawson, his wife, one share, and his boyhood school-headmaster, Charles Hicks, treasurer and secretary of the Corporation, held 197 shares [T. R. 198, 215, 218-220, 222, 225, 244, 526, 544, *ff.*; Gov. Exs. 17, 18].

The money to purchase and operate the restaurant and bar, totalling between $45,000 and $50,000, was borrowed by appellant from his mother, from his prior wife, from his then-current wife, from Hicks, and from various other persons, as well as lending companies which held appellant's wife's personal belongings as security for such loans [T. R. 251-255, 263-264, 273-274, 279-285, 309, 479-482, 496-524, 533-534, 542-543, 561-564, 566-567, 571-572, 581-587, 594-601, 606-610, 638, 672-685, 700-701, 707-709, 717-726, 742-750, 759-760; Govt. Exs. 4-B-1, 7, 29-A to 29-H, 30, 50, 50-B, 50-C; Deft. Ex. F]. These funds were, for the most part, deposited into the Corporation's bank account.

Because appellant had certain personal outstanding debts, he did not wish to jeopardize the interest of the new lenders by placing their money into a corporation owned primarily by himself; therefore appellant, although he was the prime mover behind Clawson Enterprises, Inc., placed the bulk of the stock in the hands and name of Charles Hicks, who was one of his creditors [T. R. 221, 229-230, 534-535, 641; Govt. Exs. 1-A, 1-B, 17].

Appellant's stepfather, who supplied his and Clawson's mother's money for the liquor license, and also supplied further funds for operating expenses later, took the liquor license in his (stepfather's) own name, for similar, as well as other reasons [T. R. 509-524, 533-534, 543, 638; Govt. Exs. 40, 49-A, 49-B].

Clawson's Enterprises, Inc., operated "Clawson's Restaurant" as a losing proposition. Instead of returning any profit, it required constantly new operating capital (see references above). It never declared or paid out any dividends; appellant did not receive any salary and he did not have any drawing account [T. R. 221, 287, 562-565, 609-610]. Although appellant did use some of the money brought into the Corporation, it was taken in repayment of loans he had previously made to it; moreover, the total never reached the sums he had invested of his own or other's money which he had borrowed and then used to pay the Corporation expenses.

To continue the restaurant and bar in existence, in the hope of ultimately salvaging the borrowed money invested in it, appellant and the other officials of the Corporation, continually borrowed more and more money, and put it into the Corporation's account and paid its bills [T. R. 251-262, 547-557, 640; see also references above].

The secretary-treasurer, although he was well aware of the nature of these funds, however failed to enter them all on the Corporation's records [T. R. 252-253].

The Corporation was duly organized and existed under the laws of the State of California, with by-laws, stock, etc. [T. R. 217, 545-547; Govt. Exs. 1, 1-B, 17, 18].

It had two active bank checking accounts which at times required two signature for the withdrawal of funds

[T. R. 546; Govt. Ex. 5; Deft. Exs. F, G, M, J, K]. It made hundreds of deposits and withdrawals totalling many thousands of dollars [T. R. 306-312; Govt. Exs. 20-22, 42-48; Deft. Exs. A-G, J, K, M]. It had books and records [Govt. Exs. 10, 11; T. R. 128-132, 199-210, 216, 297, 319-321, 542]. It had officers [T. R. 217, 244, 545-546] and numerous employees [T. R. 227, 244, 247; Deft. Exs. E-1 to E-5, H, I, L]. It engaged in various financial and commercial transactions, and paid numerous taxes [*E.g.,* Govt. Exs. 5, 6, 7, 10, 11, 20, 21, 22, 23, 24, 25, 26, 27, 41-A, 41-B, 42-48; Deft. Exs. B, C, D, E-1 to E-5, F, G, H, J, J-1, K, M, N, O].

In order to make certain that the books and records were kept in proper order, that function was delegated to secretary-treasurer Hicks, who had taught mathematics for many years and knew bookkeeping [T. R. 198-199, 243-246, 286, 552-555; Govt. Exs. 10, 11]. All entries in them for 1946 were made by Hicks, secretary-treasurer of the Corporation, by his friend Dittmars, and by an accountant, W. Leo, hired by Hicks [T. R. 198-213, 243, 246-248, 286, 303, 332, 552-555, 618-619].[4] Appellant did not handle any of the Corporation's books or records [T. R. 198, 199, 609].

The capital and operating expenses of between $45,000 to $50,000 of Clawson Enterprises, Inc., for the most part *borrowed money,* had to be repaid at some date subsequent to its initial borrowing [T. R. 554-555, 610, 695].

There is no evidence in the record to indicate that any of the lenders ever relinquished or forgave their loans to appellant personally or the Corporation; in fact, the

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[4]The accountant died in 1947 [T. R. 199-200, 213]. A Mrs. Gunn, accountant, hired later, failed to complete the job [T. R. 214].

record abounds with evidence to the contrary [T. R., *passim*].

The Crenshaw business district, in which the restaurant was located, showed signs of growth and business activity in 1946 [T. R. 551]. Mrs. Phyllis Clawson, who was then separated from appellant, was about to be evicted from her rented home, and had to purchase and furnish a home for herself and daughter [T. R. 381, 555-556]. She asked appellant to repay to her the loans she had made to him for the Corporation [T. R. 481, 555-556].

As a result of these factors, and because there were constant O.P.A. price problems, as well as other problems relating to supplies [T. R. 551-552], it was deemed advisable to sell the restaurant, and it was sold in the spring of 1946, for $40,000 [T. R. 10-20, 52, 134-135, 216, 228-233, 555; Govt. Exs. 23, 24, 27, 41-A, 41-B].

At first the ultimate purchasers wanted to buy all the *stock* of the Corporation; however, due to its bad financial position, its extensive obligations and outstanding loan indebtedness, the purchasers decided, in consultaton with counsel, to buy only the restaurant and its fixtures, etc., and the liquor license [T. R. 8, 13-15, 556-558; Govt. Exs. 49-D, 49-E].

The sale of these assets was duly recorded on the Corporation's books [T. R. 133-135; Govt. Exs. 10, 11].

Out of this money, appellant repaid debts, incurred on behalf of the Corporation, in part as follows: $15,000 to Mrs. Phyllis Clawson [T. R. 481, 482]; $9,000 to his mother and stepfather [T. R.]; $9,500 to creditors of Kathleen Clawson, to repay the money loaned to her which she in turn had loaned to appellant and he had loaned to the Corporation [T. R. 570-573]; $2,500 to

Nick Kalas; about $6,000 to appellant, in repayment of moneys he had invested in the Corporation prior to 1946 or had borrowed from others personally and then had loaned to the Corporation at various times; and to others.

The balance of the funds were invested and reinvested in other business enterprises, including the "Crenshaw Mirror," the boat "Artemis" and the boat "Conqueror," to be owned and operated as a part of Clawson Enterprises, Inc. [T. R. 62, 64, 74, 248-250, 558, 568-570; Govt. Ex. 8-B; Deft. Exs. B, Q, R]. Appellant's then-wife, to whom much money was still owed on loans by her to finance the Corporation's business activities in 1946, desired security on her original loan in this connection. To protect her, the boat "Artemis," for which the down payment was made out of the moneys received from the sale of the restaurant [T. R. 558], was registered in her name. This was done for that reason and also because the seller refused to accept the note of a corporation for the balance of the purchase price [T. R. 104-105, 558-560].

To sustain the Information filed against appellant, the Government here asserted throughout the trial that the Corporation Clawson Enterprises, Inc., was the *alter ego* of appellant, and that the corporate entity had to be disregarded and all its transactions treated as though they were the personal and individual transactions of appellant. It was on this theory alone that much of the prosecution's evidence, otherwise inadmissible, was admitted. When all the evidence was in, the Government changed its theory [T. R. 807, 794-795]. After the trial the theory espoused exclusively by the prosecution was that the Corporation's money handled by appellant after the sale of the restaurant and the boat "Artemis" constituted *dividends* of the Corporation to appellant.

ARGUMENT.

A.

The record does not contain that minimum quantum of evidence which the law requires to sustain a verdict of guilty upon the offense charged in this case.

(a)

In a criminal case as distinguished from a civil tax case, it is clearly not enough for the prosecution to show that money came into the hands of the taxpayer-defendant.

The prosecution was required to demonstrate further, beyond a reasonable doubt, that the money received by the appellant was, in fact, his personal and individual income, and not the income of the corporation. This the prosecution has failed to do in the instant case.

It is appellant's position that any income received by a corporation in which appellant had an interest or which he controlled, did not constitute income to appellant personally so as to make it obligatory upon appellant to file an *individual income tax return.* (*Comm'r Int. Rev. v. Moline Properties,* 131 F. 2d 388, 389, 63 S. Ct. 1132; *Eisnar v. Macomber,* 40 S. Ct. 189; *Interstate Transit Lines v. Comm'r,* 63 S. Ct. 1279; *Harwood v. Eaton,* 68 F. 2d 12, cert. den. 54 S. Ct. 715; *Comm'r Int. Rev. v. Montgomery,* 144 F. 2d 313, 315. And see also cases cited below.

It is further appellant's contention that no funds can constitute income if the funds he received from or through the corporation constituted:

(a) repayment of loans made by appellant out of his own funds;

(b) repayment of loans made to the corporation directly or through appellant by other persons;

(c) funds to be used by appellant on behalf of the corporation;

(d) or even funds received by appellant improperly, which funds are in fact the property of the corporation;

(e) loans to appellant by the corporation or by other persons. (*Weaver v. Comm'r Int. Rev.,* 58 F. 2d 755; *Trippett v. Comm'r Int. Rev.,* 118 F. 2d 764; *Macqueen Co. v. Comm'r Int. Rev.,* 67 F. 2d 857.)

Only *true income* can be considered in determining whether appellant was obliged by law to file an individual income tax return and the burden of establishing that funds received by appellant constituted *income,* was, of course, upon the prosecution. (*Gleckman v. U. S.,* 80 F. 2d 394; *Oliver v. U. S.,* 54 F. 2d 48; *Fenwick v. U. S.,* 177 F. 2d 488.)

Any circumstantial evidence equally consistent with the hypothesis of innocence as with guilt, must be viewed as supporting innocence and the burden of establishing that

appellant acted "wilfully," that is, with the specific intent as regards the corrupt and criminal motive to avoid an obligation known to exist with which the act or omission was done, etc., was also upon the prosecution. (*U. S. v. Murdock,* 54 S. Ct. 223; *Spies v. U. S.,* 63 S. Ct. 364.)

The money advanced by Clawson to the corporation and thereafter received back by him, was not taxable as his personal income, and did not have to be declared by him in a personal return.

For example, in *Weaver v. Comm'r Int. Rev.,* 58 F. 2d 755 (C. C. A. 9), the principal issue was whether the money so paid to taxpayer was the repayment of a loan or a dividend. The facts were, in part, that the corporation was organized with capital stock of $200,000.

Thereafter the stockholders of the corporation in order to increase its working capital, paid into the corporation the sum of $100,000. The stockholders did not receive any shares of stock for this money. It was understood that at some future date the sum would be returned to them.

This Court held that this money when it was returned to the stockholders by the corporation did not constitute income. The Court said, at page 756:

> "We see no basis here for taxation of this money on the theory that it is income. * * * The stockholders who advanced the money might be estopped from claiming a return of the money but as between the government and the stockholders the

actual transactions controlled in determining whether or not the money thus advanced and repaid is income within the meaning of the revenue act."

Moreover, there is a presumption that a corporate officer acts for a corporation as an agent.

Thus in *Trippett v. C. I. R.,* 118 F. 2d 764, the Court held that where a corporation, the sole stockholders of which were its president and secretary-treasurer, adopted a resolution authorizing the president to transfer and convey an oil lease to the secretary-treasurer, and the lease was conveyed to the secretary-treasurer, but the corporation declared no liquidating dividend and was not dissolved or liquidated profits subsequently resulting from the sale of the lease by the president and the secretary-treasurer were profits of the corporation for purposes of determining income and excess profits taxes; that this was so because the corporate officers could not legally contract for the sale of the lease except as agents for the corporation.

In *S. A. Macqueen Co. v. Comm'r Int. Rev.,* 67 F. 2d 857, a corporation, pursuant to resolution passed by its three stockholders who were also directors, sold real estate to its president for $85,000, and the board of directors accepted the offer of the president. The following day the president entered into an agreement with a third party to convey the real estate to him for a consideration of $150,000. The profit accruing to the president from the second sale was distributed among the three stockholders pursuant to a declaration of trust executed by the presi-

dent in which he recited the transaction and his intention to distribute the profits to the stockholders in proportion to their holdings. The conveyances were duly executed and the profits were distributed accordingly.

The Court held in that case that where a corporation transferred realty to its president who reconveyed the property to a third party at a substantial increase in price and distributed the profits to other stockholders under a declaration of trust, the profit from the sale of realty, including the profit from the second sale, was taxable to the corporation.

Oliver v. United States, 54 F. 2d 48 (1931), was a case in which the defendant was convicted for failing to file a return. However, the Court had the following to say:

> "Many transactions are shown in the evidence in which he (defendant) handled large sums of money. An examination of his bank accounts disclosed that a sum of money in excess of $450,000 passed through such accounts during the three years in question. THIS ALONE, PERHAPS, IS NOT SUFFICIENT TO JUSTIFY THE CONCLUSION THAT ALL OF THIS WAS INCOME, * * *" (Emphasis ours.)

Gleckman v. United States, 80 F. 2d 394 (1935), was a case involving Section 145b. There the Court said in part:

> ". . . the bare fact standing alone, that a man has deposited a sum of money in a bank would not prove that he owed income tax on the amount; nor

> would the bare fact that he received and cashed a check for a large amount in and of itself, suffice to establish that income tax was due on account of it."

In *United States v. Fenwick,* 177 F. 2d 488 (1949), the government was prosecuting a defendant for tax evasion and the evidence it was relying on was the increase in net worth of the defendant. However, the Government in relying upon such circumstantial evidence, had not established with certainty the defendant's net worth at the beginning of the period in question. The Court held:

> ". . . when the government relies upon the circumstances of increased net worth and expenditures in excess of reported income to establish income tax evasion it must produce evidence that excludes ALL possible available sources of taxable income from which the increased net worth and the excess expenditures could have been derived."

Quoting from *Bryan v. United States,* 175 F. 2d 223, 225, the Court said:

> "'. . . it was essential for the Government to present evidence that excluded, or tended to exclude, all other available sources from which the additional funds expended could have been derived . . . The evidence, being circumstantial. must exclude everv reasonable hypothesis other than the guilt of the Defendant . . . the case should not have been submitted to the jury since it did not exclude the hypothesis that the funds used in making some of the expenditures might have been from sources other than current business income.'"

And then concluding, the Court said:

> "The defendant is not compelled to take the witness stand; he is not compelled to make proof that he is innocent, but he must be proved guilty by the evidence beyond all reasonable doubt, and where there is doubt that all the assets of defendant are included in the government's computation of net worth, it follows that its computation can not be relied on."

In *Hargrove v. United States,* 67 F. 2d 820 (C. C. A. 5th, Tex.), the Court held that in a prosecution for wilfully failing to report income and wilfully evading tax, defendant's requested charge, though containing some inaccuracies and inadvertences, was sufficient to call the Court's attention to the law of the case as to the element of wilfulness, rendering refusal to charge its substance error. *The Court held, in this case, that the "offense of wilfully failing" to make an income tax return, and of "wilfully" evading tax are not committed unless taxpayer has actual knowledge of existence of the obligation and wrongful intent to evade it.*

In *Spies v. United States,* 63 S. Ct. 364, 317 U. S. 492, 87 L. Ed. 418 (N. Y., 1943), the Supreme Court held that without the clearest manifestation of congressional intent, it would not assume that mere knowing and intentional default in payment of income tax, where there had been no wilful failure to disclose liability, was intended to constitute a criminal offense of any degree under sections of the Revenue Act referring to "wilful" failure to pay tax or make return or attempt to defeat tax, but that the Court would expect "wilfulness" to include some element

of evil motive and want of justification in view of all the financial circumstances of the taxpayer. The Court said, at page 497 (317 U. S. 492):

> "The difference between wilful failure to pay a tax when due, which is made a misdemeanor, and wilful attempt to defeat and evade one, which is made a felony, is not easy to detect or define. Both must be wilful, and wilful, as we have said, is a word of many meanings, its construction often being influenced by its context. *United States v. Murdock,* 290 U. S. 389, 54 S. Ct. 223, 78 L. Ed. 381. It may well mean something more as applied to nonpayment of a tax than when applied to failure to make a return. Mere voluntary and purposeful, as distinguished from accidental, omission to make a timely return might meet the test of wilfulness. But in view of our traditional aversion to imprisonment for debt, *we would not without the clearest manifestation of Congressional intent assume that mere knowing and intentional default in payment of a tax where there had been no wilful failure to disclose the liability is intended to constitute a criminal offense of any degree. We would expect wilfulness in such a case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer."* (Emphasis added.)

(b)

The Internal Revenue agents who were used as "expert" witnesses admittedly did not examine all of the pertinent financial dealings of the corporation or of appellant personally. [T. R. 342 *ff.*]

They were apparently content to make only a partial investigation, because of their adoption of the legal theory

that all that was needed in this case was a lifting of the corporate veil, partially. [T. R. 388-390.]

The theory of the agents in investigating the case was to treat the corporation as non-existent, as the *"alter ego"* of appellant, and to treat its operations as though they were the personal business transactions of appellant as an individual [T. R. 343-349], not even bothering to audit all of the corporation's books and records which the agent merely "looked over" [T. R. 344]; they did not examine the bank ledger sheets and records to ascertain the source of the money deposited to the corporation's account or to ascertain the nature of the financial transaction. [T. R. 345-349, 353, 368-369, 375-376, 378.] Nevertheless they were permitted to state conclusions and opinions on a basis lacking in required evidentiary support.

They took no account of any loans to the corporation [T. R. 395, 398, 400, 408-409, 410, 412, 421, 424], although they admitted that "if he (appellant) loaned money to the corporation, part of those withdrawals he made could be applied against the loans that he made to the corporation." [T. R. 398.]

They decided that the corporation's bank account was to be treated as though it were appellant's personal bank account, and made their computations and testified as to findings based upon these hypotheses as though they were provable facts. [See *e. g.,* T. R. 400-404.]

But the prosecution, after the evidence was all in, admittedly did not rely upon the *"alter ego"* theory at all. [T. R. 794-795, 801, 806, 807.]

To have offered much of the evidence ostensibly on the *"alter ego"* theory, while in fact not pressing that theory,

was highly prejudicial to appellant, and requires reversal of this case.

Moreover, examination of the evidence, tested by the law, shows that it is clearly insufficient to sustain the verdict on any theory.

The corporate entity is, of course, a fundamental part of our tax structure. The Internal Revenue Code, Section 3797(a)(3), defines corporations, and under the Code a separate tax is imposed on corporations (Internal Revenue Code, Sec. 13 *et seq.*). Many other references to corporations as such are found in the Code.

As early as 1918 the Supreme Court of the United States recognized the doctrine of separate corporate entity for tax purposes (*Lynah v. Hornby,* 38 S. Ct. 543). The famous case of *Eisnar v. Macomber,* 40 S. Ct. 189, holding that stock dividends were not income, rested upon a premise that a corporation is a separate corporate entity.

This position was reaffirmed in *Interstate Transit Lines v. Comm'r,* 63 S. Ct. 1279 (1943), and in the *Moline Properties* case, 63 S. Ct. 1132 (1943), when the Supreme Court upheld the separateness of the corporation against the argument that the gains of a corporation, organized to hold title to property by an individual at the suggestion of those from whom he bought the property, should be regarded as the individual gains of the sole stockholder. The Court said that the corporation was a distinct entity despite purely utilitarian and *alter ego* aspects of its existence. (See also *Harwood v. Eaton,* 68 F. 2d 12, and for California, *Wenban Estate v. Hewlett,* 227 Pac. 723.) Reference is made to California cases because the Court instructed the jury on California law in this connection.

In *Pickwick Corp. v. Welch,* 21 Fed. Supp. 664 (1936), the District Court for the Southern District of California reviewed several cases in which the doctrine was disregarded and then said:

> "The doctrine of corporate entity is one of substance and validity. It should be ignored with caution and only when the circumstances clearly justify it. The theory of the *alter ego* has been adopted by the courts to prevent injustice, in those cases where the fiction of a corporate entity has been used as a subterfuge to defeat public convenience or to perpetuate a wrong; it should never be invoked to work an injustice or give an unfair advantage." (Citing cases, including *Old Colony Trust v. Comm'r,* 69 F. 2d 699, and others.)

See also *Minifie v. Rowley,* 202 Pac. 673, in which it was said that the corporate entity might be disregarded if:

> "The facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances sanction a fraud or promote injustice."

Or, as was said in the *Wenban* case (above), the corporate entity will be disregarded when necessary to (1) redress fraud, (2) protect the rights of third persons, or (3) prevent a palpable injustice.

Before a corporate entity can be disregarded, it is not enough that the company is organized and controlled, and its affairs so managed as to make it "merely an instrumentality, conduit or adjunct of its stockholders, but it must further appear that they are the business conduits and *alter ego* of one another *and that to recognize their separate entities would aid the consummation of a wrong.*"

(*Erkenbacker v. Grant* (1921), 200 Pac. 641, cited and approved in many cases.)

It must be shown by evidence that the organization of the corporation or the act done is fraudulent or prompted by dishonesty or that the corporation committed or intended to commit a fraud or that injustice would be done if the separate entity were not disregarded. (See *Minifie* case, *Erkenbacker* case, *Wenban* case, above.) Therefore this doctrine may be invoked only by pleading and proving the facts.

See also:

Corning Glass Works v. Comm'r, 9 B. T. A. 771;

Corning Glass Works v. Lucas, 37 F. 2d 798, 68 A. L. R. 736, 50 S. Ct. 348;

New Colonia Ice v. Helvering, 54 S. Ct. 788;

Eichelberger, et al. v. Arlington Building, Inc., 280 Fed. 997 (1922).

With regard to tax matters similar rules obtain. The corporation is recognized even when wholly owned by persons who would be otherwise taxed.

For instance, in Comm'r Int. Rev. v. Montgomery, 144 F. 2d 313, the defendant, a contractor, agreed to provide materials and perform all work in building a certain building. During the period of construction he assigned the contract to a corporation consisting of himself, his wife and three children (he taking two voting shares, his wife one, and 97 non-voting to his children). The profits on the work completed as of the time of the assignment to the corporation was included in his individual return. The profits on work done afterward were returned by the corporation. It was this last move that was in dispute.

The Court there held the procedure to be a legal one. The Court pointed out that the corporation conducted itself like a corporation, that it kept books, paid corporation taxes, and the profits arising from the assigned contract were regularly returned as income by the corporation and dividends were regularly declared to the stockholders and returned for them as their income.

In the instant case *Clawson Enterprises, Inc.,* kept books, paid various taxes, etc. However, it had no profits, only losses.

Thus, in tax matters "the tendency is not to ignore the corporate entity unless it be used to defraud, but rather when natural persons are using corporate forms to do their business, they and their corporations are held to the literal consequences." (*Bancker v. Comm'r,* 76 F. 2d 1, 2, cited with approval in *Comm'r v. Moline Properties,* 131 F. 2d 388, 389 (1942).)

In cases in which the courts have disregarded the corporate entity it was done on the primary ground that the corporation was organized only to set up a distinct entity and as a shell, without any true business function.

And in order to hold individuals upon a theory disregarding the corporation as a fiction, appropriate facts must be pleaded to show a cause of action against the individuals and not against the corporation or against both. (*Nelson v. Parker,* 286 Pac. 1078; *Minifie* case, above.)

Also, the corporate entity is not to be disregarded solely because the ownership of stock is concentrated in one man. (See *Minifie, Erkenbacker, Wenban* cases, above, and *Mills v. Richmond Co.,* 219 Pac. 465, and cases cited. For a fuller discussion of this subject, see 6a Cal. Jur. 78, note 13.)

The corporate entity may not be disregarded upon a mere showing that the individual sole-owner and the corporation are for all intents and purposes but one and the same. ". . . THERE MUST BE A FURTHER SHOWING THAT AS A RESULT OF THE DOUBLE RELATIONSHIP FRAUD OR INJUSTICE WILL INURE TO A THIRD PERSON . . ." (*Wenban* case, *supra.*)

See *Comm'r v. Court Holding Corp.,* 324 U. S. 331, in which husband and wife formed a corporation. They sold its sole asset, an apartment house. Negotiations began while the corporation existed. The corporation was dissolved before the negotiations were completed. The Tax Commissioner taxed the corporation. This was *sustained* by the Supreme Court on theories which militate against the prosecution's theory of the law in the instant case.

Whenever a person receives funds while acting as agent of the corporation, the benefits adhere to the corporation. (*Wichita v. Comm'r,* 162 F. 2d 513; *Fairfield S. S. Corporation v. Comm'r Int. Rev.,* 157 F. 2d 321.)

And even if appellant illegally held the proceeds of the sale of the restaurant and the "Artemis," the income could not be regarded as his individual income for income tax purposes. (*Comm'r v. Wilcox,* 66 S. Ct. 546.)

Even a change of legal business form to avoid payment of taxes, is legal. (See *e. g., Chisholm v. Comm'r,* 79 F. 2d 14; *Weeks v. Sibley,* 269 Fed. 155.)

> "The right to change the status of an organization, or to dissolve an organization in any legal manner, is not made ineffectual because the motive impelling the change is to reduce or avoid taxation in the future." (*Weeks* case, *supra.*)

B.

The District Court erred in denying appellant's motion [C. R. 4-7] for a Bill of Particulars. [C. R. 8.]

C.

The District Court erred in refusing to entertain appellant's motion [C. R. 9-12] for return of illegally seized property and for the suppression of evidence. [C. R. 13, lines 15-16; p. 14, lines 21-22; T. R. 48-.....]

Appellant should have been permitted to present his motion to adduce evidence and to take all other steps necessary to show the facts upon which the motion was based. [C. R. .....]

The books and records in question were subsequently used extensively by the prosecution in proof of its case. [See *e. g.,* Government Exs. 10, 11, 17, 18, 19, 40, 41-A, 41-B, 42-48.]

Such a fundamental right should not have been denied to him. The denial constituted denial of due process. (Rule 41 (a), (b), (c), (d) and (e), *Federal Rules of Criminal Procedure;* Amendments IV, V and VI, *Con-*

stitution of the United States; Silverthorne Lumber Co. v. U. S., 251 U. S. 385; *Meeks v. U. S.,* 232 U. S. 383; *Gouled v. U. S.,* 255 U. S. 298; *Agnello v. U. S.,* 269 U. S. 20; *Gambino v. U. S.,* 274 U. S. 310.)

D.

The District Court erred in permitting the prosecution to introduce the following evidence:

(a) All the testimony and evidence relating to the stock issuance applications, incorporation of and dealings by Clawson Enterprises, Inc.

(b) Expert opinion of internal revenue agents, which was without foundation, based on erroneous view of the law and based in part on material outside the record. [T. R. 340 *ff.*]

(c) The entire testimony of Government witness John H. Whalen. [T. R. 122-196, 325-326.]

(d) Hearsay testimony as to statements by Mr. Hicks [T. R. 355] and others. [T. R. 371-372.]

(e) Hearsay testimony of Mr. Whitecotton. [See "J" below, and Government Exs. 52, 53 and 54.]

E.

The District Court erred in refusing to accord to appellant the opportunity of obtaining evidence to refute matters improperly placed before the jury as to which appellant was caught by surprise, as developed by the hearsay testimony of Mr. Whitecotton and by Government Exhibits 52, 53 and 54. [Tr. R. 701-702, 712-713, 720-723, 731, 761-765, 785-786.]

F.

Appellant was denied due process by virtue of the action of the prosecutor in shifting his theory of the case after all of the evidence was in the record.

Much of the evidence came into the record on the *"alter ego"* theory. This theory was abandoned by the Government. The presence of this evidence and the shift in the prosecution's theories resulted in a denial of due process to appellant.

G.

The Court erred in giving to the jury the following instructions presented by the Government.

(a) Government's Instruction No. 2.

> If you find that there were any gains, profits, or income received by the defendant which were not reported, it makes no difference as far as the question of taxability is concerned whether such income was lawfully received or unlawfully received, inasmuch as both were taxable and should have been reported.

(b) Government's Instruction No. 5.

> Every individual having for the taxable year 1946 a gross income of $500 or more shall make a return which shall contain or be verified by a written declaration that it is made under the penalties of perjury. Such return shall set forth in such cases, and to such extent, and in such detail, as the Commissioner with the approval of the Secretary may by regulations prescribe, the items of gross income and the deductions and credits allowed under this chapter, and such other information for the purpose of carrying out the provisions of this chapter as may be prescribed by such regulations.

(c) Government's Instruction No. 6.

The gist of the offense charged in the information is wilful failure on the part of the defendant to file a return. To establish this charge, the Government must prove (1) that the defendant was a person required by law to make a return for the year 1946; (2) that he failed to file a return for that year at the time required by law; and (3) that the failure to file such return was wilful.

(d) Government's Instruction No. 8.

Wilful failure to make a return when one is required is a misdemeanor without regard to existence of a tax liability.

(e) Government's Instruction No. 9.

Every person subject to income tax, "except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown" in an income tax return.

(f) Government's Instruction No. 10.

"Wilful," in the statute *which makes a wilful attempt to evade taxes a crime, refers to the state of mind in which the act of evasion was done.*

It includes several states of mind, any one of which may be the wilfulness necessary to make up the crime.

Wilfulness includes doing an act with a bad purpose; it includes doing an act without a justifiable excuse. It includes doing an act without ground for believing that the act is lawful, and it also includes doing an act with careless disregard for whether or not one has the right to so act.

(g) Government's Instruction No. 17.

You are instructed that under the income tax laws the term "dividend" means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year without regard to the amount of the earnings and profits at the time the distribution was made.

(h) Government's Instruction No. 18.

You are instructed that if you find from all of the evidence that the defendant was the real owner of substantially all of the stock of the corporation known as Clawson Enterprises, Inc., and used funds belonging to that corporation for his own personal use, you may find that such use constituted the use of a dividend constructively received by him from such corporation, even though no formal declaration of dividend was made by the corporation, as such declaration is unnecessary where substantially all the stock of the corporation was owned by a single individual.

(i) Government's Instruction No. .....

You are also instructed that substance and not form controls in the application of income tax laws which deal with realities and looks at entire transactions and, further, that any distribution made by a corporation to its shareholders out of its *earnings or*

profits accumulated since 1913 *is a dividend,* a formal declaration of dividend by a corporation not being essential.

(j) Government's Instruction No. 21.

You are instructed that payments made by a corporation out of its earnings or profits may be taxable to the shareholders as dividends, even though (1) they purport to be based upon a consideration and are not designated as dividends; (2) they are not in proportion to stockholdings; or (3) there is no formal declaration of a dividend.

H.

The Court erred in refusing to give to the jury the following specific instructions requested by appellant:

(a) Defendant's Instruction No. 2.

It is not charged that Clawson Enterprises, Inc., or Clawson's Restaurant, or the Crenshaw Mirror, or the Clawson-Miller Publishing Co., or the boat "Artemis," or the vessel "Conqueror" filed or were required to file any income tax return or to pay any income tax to the Government for the year 1946. [C. T. 16.]

(b) Defendant's Instruction No. 3.

It is immaterial whether or not Clawson Enterprises, Inc., had any income during 1946. [C. T. 17.]

(c) Defendant's Instruction No. 8.

The losses or expenses of a corporation cannot be deducted by its sole stockholder from his personal income in determining his income tax, or vice versa. [C. T. 17.]

(d) Defendant's Instruction No. 9.

Nor can the receipts of a corporation be chargeable to its stockholders or sole stockholder for income tax purposes. [C. T. 17.]

(e) Defendant's Instruction No. 11.

The Court is requested to give its standard instructions on reasonable doubt, on circumstantial evidence, on the meaning of "wilfully" as defined in the *Murdock* and *Spies* cases, presumption of innocence. [C. T. 17.]

(f) Defendant's Instruction No. 12.

You cannot find that the defendant acted wilfully if he did not understand clearly the requirements of the law as they applied to him in connection with income tax returns for 1946. [C. T. 17.]

(g) Defendant's Instruction No. 13.

You cannot find that the defendant acted wilfully if he is shown to have honestly believed that under the circumstances presented in this case he did not have to file any return for 1946, or if he relied upon the advice of an accountant or an attorney as to his rights and obligations in that regard. [C. T. 18.]

(h) Defendant's Instruction No. 18.

Money misappropriated, embezzled or stolen does not constitute income, either gross or net, to the person who misappropriates, embezzles or steals the money in question. [C. T. 18.]

(i) Defendant's Instruction No. 19.

If the defendant is found by you to have taken funds of Clawson Enterprises, Inc., in 1946 for his own personal use, without being duly authorized or

empowered to do so by the corporation, you cannot include funds so taken by him as a part of his income, if any, for 1946, since such an unauthorized taking of money would constitute theft or embezzlement on his part. [C. T. 18.]

(j) Defendant's Instruction No. 22.

You are not permitted to guess or speculate as to whether any of the money which may be shown to have passed into Clawson's hands in 1946 was actually income.

Unless the Government proves beyond a reasonable doubt that money received by Clawson actually was income to him and that he knew it was income and received or accepted it as income, you must find Clawson not guilty in this case. [C. T. 19.]

(k) Defendant's Requested Instruction No. 25.

There is no evidence in this case that the corporation was ever dissolved or liquidated, and there is no evidence whatsoever that any dividends were declared or paid by the corporation. [C. T. 19.]

(l) Defendant's Requested Instruction No. 26.

Any income received from the sale of the restaurant and bar or the boat "Artemis" was income of the corporation and not of the defendant personally. [C. T. 19.]

(m) Defendant's Requested Instruction No. 23.

You are not bound to accept the testimony or opinion of any government agent or expert regarding any of the matters as to which he may have testified as an expert, or as to which he gave an opinion.

You may disregard the entire testimony of the expert in that regard.

You must disregard the opinion of an expert witness if it is shown that the witness did not take into account all of the facts concerning the financial matters which involved the defendant in this case. [C. T. 22.]

(n) Defendant's Requested Instruction No. 24.

You are not permitted to speculate or guess as to whether any funds received by the defendant personally constituted income.

The Government must prove beyond a reasonable doubt that any such funds received by the defendant actually constituted income, and did not constitute the repayment of a loan, etc. [C. T. 22.]

(o) Defendant's Requested Instruction No. 25.

There is no evidence in this case that the corporation was ever dissolved or liquidated, and there is no evidence whatsoever that any dividends were actually declared or paid by the corporation. [C. T. 23.]

(p) Defendant's Requested Instruction No. 26.

Any income received from the sale of the restaurant and bar or the boat "Artemis" was income of the corporation and not of the defendant personally. [C. T. 23.]

(q) Defendant's Requested Instruction No. 27.

The doctrine of corporate entity cannot be ignored.

The theory of the *alter ego* can be utilized only in order to prevent injustice, where the corporation has been used as a subterfuge to perpetuate a wrong or to defraud. [C. T. 23.]

(r) Defendant's Requested Instruction No. 28.

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. [C. T. 23-24.]

(s) Defendant's Requested Instruction No. 29.

The corporate *form* must be unreal or a sham before the Treasury may disregard it.

Whatever may have been the purpose of organizing the corporation, so long as that purpose is the equivalent of business activity, or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. [C. T. 24.]

I.

The Court should have granted the motion for a new trial. [C. R. 32-35, 36.]

The questions presented on this appeal as to procedural steps and violations of appellant's due process rights discussed previously disclosing the necessity for reversal, were to a large extent presented to the lower Court upon the motion for a new trial. [C. R. 32-35.]

The District Court erred in denying that motion. [C. R. 36.]

J.

The District Court erred in admitting into evidence the second-degree hearsay testimony of Dr. George O. Whitecotton [T. R. 647-665] and in admitting the hearsay medical record document, Government's Exhibits 52, 53 and 54. Also, the documents 53 and 54 were privileged since the person to whom the medical records referred, who was then 86 years of age [T. R. 662] had not waived her privilege and the prosecution therefore illegally obtained and utilized it. [T. R. 648.]

Moreover, the 1937 matter had no relation to any issue before the Court.

The District Court received this document in evidence [Goverment Ex. 52, T. R. 668] and permitted Dr. Whitecotton to testify concerning its terms although he admitted that the financial information furnished was based on Mrs. Name's statements and he admitted also that the very hospital record he was using as the sole basis for his testimony stated that Mrs. Names was then 86 years af age, and was "senile," "confused" [T. R. 647-648, 658 *ff*], "incoherent," "unreliable," "forgetful" to the extent that she disclaimed having a daughter.

K.

In the light of the circumstances disclosed by the entire record, the sentence imposed upon defendant was clearly excessive. This Court has the power to, and should reduce that sentence.

Conclusion.

The judgment below should be set aside with instructions to the District Court to enter a verdict and judgment of not guilty. In the alternative, the judgment should be set aside and appellant granted a new trial. The sentence should be set aside.

Respectfully submitted,

STRONG & SCHWARTZ,
By WILLIAM STRONG,
Attorneys for Appellant.